

TO: Files

CC: San Diego Audit Committee

FROM: Willkie Farr & Gallagher LLP

RE: Interview of Charles Hogquist on April 19, 2006

DATED: May 23, 2006

On April 19, 2006, Carolyn Miller, in Willkie Farr & Gallagher LLP's capacity as counsel to the Audit Committee, interviewed Charles Hogquist. Mr. Hogquist was not represented by counsel at this interview. Also in attendance were Lynn Turner of the Audit Committee, Donielle Evans of KPMG, and Raymond Sarola of Willkie Farr & Gallagher LLP. The interview took place in a conference room on the 3rd floor of the City Administration Building in San Diego and lasted approximately two hours.

The following memorandum reflects my thoughts, impressions, and opinions regarding our meeting with Charles Hogquist, and constitutes protected attorney work product. It is not, nor is it intended to be, a substantially verbatim record of the interview.

Warnings

Ms. Miller informed Mr. Hogquist that the scope of the interview would be determined by the Audit Committee's investigation. She explained that she represents the Audit Committee and not Mr. Hogquist personally. She stated that the interview was not privileged, and that information obtained in the interview may be used in the Audit Committee's public report, or turned over to the government or KPMG. Ms. Miller told Mr. Hogquist that the information he provides will not be shared with other witnesses until the release of the Audit Committee's report, and asked that he not discuss this interview with others who may still be interviewed.

Background

Ms. Miller asked Mr. Hogquist to explain his education and employment history. Ms. Hogquist has a Bachelor's degree from the City University of New York at Queens, and a law degree from the University of San Diego. Since graduating from law school, Mr. Hogquist has taken additional courses at a local college, and attended police management training classes. He started with the San Diego Police Department as an officer in 1978, was promoted to Sergeant in 1984, and then to Lieutenant (Ocean Beach/Point Loma Region) in 1992, which is the position he currently holds.

Mr. Hogquist was elected and sworn in as the police representative to the SDCERS Board in 2003. When he was elected, the Board consisted of thirteen members,

including representatives from the Police and Fire Unions. Mr. Hogquist explained that the election for a union representative is held by the members of that bargaining unit. Ms. Miller asked how he came to be elected, and he responded that at the time there were retirement issues that police officers cared about and his co-workers filled out the paperwork necessary for his candidacy. He ran against the incumbent police representative Tom Rhodes and won. Mr. Hogquist explained that he felt Mr. Rhodes was a good trustee, but had personality quirks that turned some people off. Mr. Rhodes did not educate him on SDCERS Board issues when he was elected. He had no prior involvement with retirement issues, and served until the Board was reconstituted in April 2005.

Ms. Miller asked if he served on any committees while on the Board, and he responded that he was a member of the SDCERS Rules Committee, and said that he might have served on the Health Advisory Committee as well. Ms. Miller asked him to describe the role of the Rules Committee and he stated that it was responsible for reviewing the rules that dictated the operation of the Board. Ms. Miller asked him to explain his understanding of his main responsibility as a SDCERS Board member. Mr. Hogquist felt that his main responsibility as a Board member was to review the information he was given and vote as a trustee of the pension system. Ms. Miller asked if he was compensated for his service on the Board, and he jokingly responded that he was given free lunch.

SDCERS Board Procedure

Ms. Miller asked Mr. Hogquist to describe how the SDCERS Board met to carry out its business. He explained that the full SDCERS Board met once a month for regular meetings, and met for special meetings as needed. There was a fixed agenda for the meetings that was prepared by the SDCERS staff, so the meetings lasted until all items listed were handled. The agenda was sent to each Board member's house one week before a meeting, along with the minutes of the previous meeting, staff reports, and an agenda of items to be discussed at the upcoming meeting. Ms. Miller asked if he could submit an item for the agenda. Mr. Hogquist believed that there was a process to submit an item for placement on the agenda, but had never done so himself and was unaware of others who had.

Mr. Hogquist would call Lawrence Grissom (SDCERS Administrator) or Paul Barnett (SDCERS Deputy Administrator) if he needed clarification or supporting documents, and mentioned that he called Mr. Grissom every couple of months in this regard. Ms. Miller asked his opinion of Mr. Grissom and he described Mr. Grissom as a capable administrator who was able to accomplish much in trying times. It was Mr. Grissom's responsibility to see that the SDCERS staff responded to the plan participants' requests for information. The SDCERS staff included Mr. Barnett, Lorainne Chapin, and staff who worked in the medical office, created financial plans, and processed employee claims. Mr. Hogquist noted that he usually went to Mr. Grissom with questions because most issues that arose were administrative in nature, such as requests from police officers for information, rather than legal. Ms. Chapin was in attendance at all Board meetings, but Mr. Hogquist could not remember anything specific that he spoke to her about.

The arrival of the binder of materials in preparation for the upcoming meeting was usually the first time that Mr. Hogquist saw the minutes from the previous meeting. These minutes were prepared by the Board secretary, and were intended to be a summary of the

meeting. In the beginning of his service, meetings were recorded on an audio CD, but after Michael Aguirre was elected, and due to allegations concerning the Retirement Board, meetings were videotaped. Ms. Miller asked who had made the decision to videotape these meetings, and Mr. Hogquist replied that he could not recall, though it might have been Fred Pierce (SDCERS Board President). Ms. Miller asked if he recalled any concerns that were raised regarding the accuracy of the minutes that were prepared. Mr. Hogquist responded that normally the minutes were accepted by the Board without comment as a consent item. He did not remember any issues with the accuracy of the minutes.

At their monthly meetings, the SDCERS Board would receive updates on the assets and structure of the system. Investment updates were given quarterly, except the Investment Committee would discuss this issue more frequently. Mr. Hogquist said that he was on the mailing list for many kinds of financial updates, which he would read if he had time. For the most part, though, he usually relied on staff and summaries for financial information. Mr. Hogquist felt that he did not have enough training to understand the relevant financial information, but was not concerned with this because his primary role was to protect the assets of the system and provide information to system participants.

Mr. Turner asked whether the Board received updates on the employer contribution and other reserves. Mr. Hogquist stated that this information was not included in the packets received by Board members in advance of Board meetings, though he was informed that it had been included in the past. He did not know why this change took place, and stated that he only asked about changes that occurred during his period of service. One change that occurred during his time on the Board was that certain personal information, which was part of the public record, was removed from the internet site, though it remained available on Board reports. Mr. Hogquist explained that this was due to plan participants' privacy concerns.

Ms. Miller then asked about the procedure for holding closed session meetings. Mr. Hogquist explained that at every SDCERS Board meeting, usually towards the end, there was a closed session portion that dealt with litigation and personal matters. The public, secretary, and most staff would leave for the closed session, and only the Board members and staff who were presenting a report would remain. These sessions were recorded on audio CD.

Ms. Miller asked Mr. Hogquist to describe the training he received as a Board member. He remembered attending a few Board training seminars, but missed others. He believed that the new Board members receive more extensive training on issues like fiduciary duty and disclosure responsibilities. Ms. Miller asked Mr. Hogquist for his understanding of his fiduciary responsibilities as a Board member, and Mr. Hogquist replied that he was to make sure that the members of the system received the benefits to which they were entitled and that the system made good investments. When asked what his responsibilities were concerning disclosure, Mr. Hogquist stated that he had to make sure that he had no conflicts of interest. He stated that responsibilities relating to financial disclosure were never discussed by the Board. Mr. Hogquist only disclosed one potential conflict, and did not recall other members disclosing conflicts, though some would abstain from voting without giving a reason.

The Role of SDCERS General Counsel and Outside Counsel

Lorraine Chapin was the SDCERS General Counsel during Mr. Hogquist's tenure. Ms. Miller asked whether outside counsel were hired globally or for a particular task. Mr. Hogquist responded that outside counsel were hired for particular tasks, though he could not recall a specific task they were hired to address. Ms. Miller asked whether the Board had ever hired bankruptcy counsel. Mr. Hogquist responded that the SDCERS Board did hire bankruptcy counsel, probably in the fall of 2004, to determine what would happen if the City went bankrupt. These meetings were held in closed session and Mr. Hogquist did not remember the name of the bankruptcy counsel.

SDCERS' Actuary

Ms. Miller asked Mr. Hogquist who the pension actuary was during his tenure on the Board. He knew that the actuary was contracted by SDCERS, but could not remember his name. Ms. Miller asked if it was Rick Roeder and Mr. Hogquist replied that it was. Ms. Miller asked about Mr. Roeder's role and Mr. Hogquist explained that he presented summaries of his annual reports concerning actuarial rates to the Board and was available to answer questions. Mr. Roeder discussed the assumptions underlying his actuarial analysis, and Mr. Hogquist could not remember the Board ever challenging these assumptions. Mr. Turner asked who developed these assumptions and Mr. Hogquist answered that they were a combination of Mr. Roeder's own assumptions, and those suggested by the SDCERS staff or City Manager. Mr. Turner asked Mr. Hogquist to explain the SDCERS Board's role regarding these assumptions. Mr. Hogquist stated that it was the Board's responsibility to ensure that the assumptions were reasonable, and he noted that certain Board members had experience in this regard (Richard Vortmann and Mary Vattimo). The Board did consider replacing Mr. Roeder but never took action to do so. Ms. Miller asked Mr. Hogquist if he had an opinion of Mr. Roeder's work and he stated that he did not have an opinion on this issue, and did not understand the totality of Mr. Roeder's reports. According to Mr. Hogquist, Mr. Roeder seemed credible and Mr. Hogquist did not feel as though he was trying to reduce the City's contributions. Ms. Miller asked if Mr. Hogquist was familiar with the term "NPO" and he replied that he was not. Ms. Miller asked if he was aware of Mr. Roeder trying to reduce this value, and he responded that he was not aware of this. Mr. Hogquist further stated that he had no personal contact with Mr. Roeder.

Contact with City Agencies and Officials

Ms. Miller asked about the SDCERS Board's interaction with the City Attorney's Office. Mr. Hogquist stated that representatives from the City Attorney's Office were sometimes present at Board meetings, either to make presentations or to observe the proceedings. Mr. Hogquist was unable to recall anything specific about any of their presentations, except that they might have involved an interpretation of the Municipal Code. Ms. Miller asked him to describe the nature of his interaction with the City Attorney's Office, and he replied that he had no interaction with the City Attorney's Office during his tenure on the Board, and was unaware of its role with respect to SDCERS.

Ms. Miller then asked about the SDCERS Board's interaction with the City Council. As a member of the SDCERS Board, Mr. Hogquist stated that he dealt only with City Council staff, not Councilmembers directly. He explained that it is against the law for

Councilmembers to make requests for service directly to City employees, in order to prevent patronage. Therefore, a member of a Councilmember's staff would contact Mr. Hogquist, and his interaction would be with that staff member and not the Councilmember personally.

Mr. Hogquist did not recall having any interaction with the Mayor's office, the City Manager, or the City Treasurer's Office. (Mary Vattimo served on the SDCERS Board, but Mr. Hogquist did not recall her making any presentations in her capacity as Treasurer.)

Manager's Proposals 1 and 2

Ms. Miller asked Mr. Hogquist to explain how he first learned how the City's pension contributions were calculated. He replied that he learned about MP1 and MP2 once he joined the SDCERS Board. Before his service on the Board, his only knowledge was as a beneficiary of the pension system. He knew from a book that he was given when he was first hired by the City that both he and the City were contributing to his personal retirement fund, and later learned that the City began picking up a portion of the employee contribution in the late 1980's in lieu of a salary increase. Ms. Miller asked if this information was conveyed to the unions and he responded that Tom Rose had informed the POA (Police Officers Association) Board and the information was probably in the newspaper, but he noted that police officers don't understand "high finance." Ms. Miller asked Mr. Hogquist if he received any formal training about these issues when he joined the Board, and he replied that he did not. He stated that City contributions were handled by the Finance Committee of the SDCERS Board, of which he was not a member.

Mr. Hogquist recalled Diann Shipione and others raising the issue of the City not making proper contributions to SDCERS, though he could not recall the Board taking action in response to these allegations. Mr. Turner asked Mr. Hogquist whether he had views on the City's failure to make the proper contributions. Mr. Hogquist replied that part of him thought it was wrong, but another part felt that it wasn't a problem until the City couldn't pay their bill. He viewed the UAAL as a mortgage and said that the City had 15 or 30 years to pay the UAAL, so there was no reason to bankrupt the City so that it could be paid off in three years. Mr. Turner asked if he had any concern with the City's ability to pay its contribution during the 30-year period. Mr. Hogquist responded that this issue was discussed with the SDCERS actuary in closed session and therefore he "couldn't talk about that."

Mr. Hogquist noted that settlements to various lawsuits had increased the City's contribution and he was comfortable with those increases. The *Gleason* lawsuit was close to settling once Mr. Hogquist joined the Board, and he stated that he didn't research past activities to determine the facts underlying that litigation. He stated that he felt the plaintiff acted improperly and that the participants did not benefit from the settlement as much as the plaintiff's attorney did.

Ms. Miller asked Mr. Hogquist if he ever had any involvement in the Meet & Confer process. He responded that he had no role in this process when he was a policeman, and while he served on the SDCERS Board the unions all had contracts, so the issue never came up. After he left the SDCERS Board, he was elected to the Police Union Board where he was part of the union's negotiating team.

Retirement Benefit Programs

Ms. Miller next asked Mr. Hogquist to explain his understanding of the purchase of service credit ("PSC") program. Mr. Hogquist responded that the City created the PSC program in 1996 or 1998, based on a program by CALPERS (California Public Employees' Retirement System) that allowed members to pay the employer/employee contribution in order to buy up to five years of time to increase their benefits. Mr. Hogquist did not know how the cost of these credits was determined, and noted that the Board never did a calculation as time went on to determine whether the amount charged was still correct. Ms. Miller asked him if he purchased credits through this program and he replied that he purchased his own credits prior to his Board service. When the Board decided to raise the cost of credits, it also decided to give the public a 60-day advance notice of the price raise. Mr. Hogquist explained that it was important to let people know about the change in their benefits, so the Board made an announcement and engaged in a mailing to plan participants to inform them in advance of the price change. Mr. Hogquist stated that Mr. Roeder had made a presentation to the Board on the effect of the new price on the system's finances, but that the effect was difficult to predict because no one knew how many members were going to purchase credits at the lower price after the advance notice. Prior to the price increase, it was typical for people to purchase credits at the end of their employment rather than earlier on, so it was difficult to predict how many participants would purchase during the 60-day advance notice period. Mr. Turner asked if the Board was given various projections of the impact this decision would have on the fund, and Mr. Hogquist replied that he did not recall whether the Board was given projections, or whether they requested them. In the end, more members purchased credits at the lower price than the Board expected. Mr. Turner inquired whether employees asked if the new price was a "good deal," and he responded that they were told it was their decision and that some people probably made a poor decision for their own situations.

Turning to post-retirement health care, Ms. Miller asked Mr. Hogquist to explain how he came to learn about this issue. Mr. Hogquist replied that since leaving the Board, he has learned more about the funding of post-retirement health care. During his tenure on the Board, he wanted to know about this issue because he read that San Diego was the only city that paid medical benefits upon retirement. Mr. Turner asked if he knew that health care was paid from the waterfall. He replied that he asked Lorainne Chapin about this issue in or around September 2004 and was told that health care was funded from the waterfall according to the Municipal Code. Mr. Hogquist's understanding of the waterfall, however, changed every month and he never felt that he received a satisfactory answer from anyone on how the waterfall worked. He stated that he was concerned that the City could get paid "once on the front, and once on the back," implying that the City could manipulate the waterfall to its benefit. Mr. Turner stated that there were different interpretations of the waterfall, and asked if the SDCERS Board had ever sought a consistent application. Mr. Hogquist replied that they had not. By the end of his term, the Board was dealing with many other controversial issues and they never got to a full discussion of the waterfall. Board discussions concerning the tax implications of the health care funding mechanism took place after Mr. Hogquist had left the Board.

Ms. Miller asked about Fire Union President Ron Saathoff's pension benefits. Mr. Hogquist replied that the Board voted on Mr. Saathoff's pension benefits, and Mr. Hogquist explained that the reason these benefits were backdated twelve months was because it took the

City Auditor that long to investigate this issue. He stated that an application for retirement benefits must first go the City Auditor for a determination of the recipient's proper salary. Mr. Hogquist also recalled that Mr. Saathoff abstained from the vote approving his benefits.

Surplus Earnings

Ms. Miller asked Mr. Hogquist to explain surplus earnings and he defined them as "everything that the system earned above actuarial rate and operating expenses." His understanding was derived from Board presentations and discussions. Ms. Miller asked if the Board ever discussed the possibility of keeping this money in the fund. He replied that they did, but the use of these funds was dictated by the Municipal Code which the Board cannot change. The Board did prepare and deliver to the Mayor resolutions for the City Council to amend the Municipal Code, but these were never put on the docket. Mr. Hogquist suggested that it was possible the Mayor and City Manager didn't want the changes made. Mr. Turner then asked him what changes were proposed. He could not recall the specifics of these proposed changes, or if the Board was ever told why these changes never made the City Council docket.

The Blue Ribbon Committee

Ms. Miller asked if Mr. Hogquist was aware of the Blue Ribbon Committee ("BRC") at the time the Committee was gathering facts for its investigation. He replied that he was, but he did not believe that the BRC ever made a presentation to the Board, and he never attended its other meetings. Mr. Hogquist was shown a presentation to the SDCERS Board dated February 6, 2003, regarding the BRC (Exhibit 1). Ms. Miller asked if he recognized this document and he stated that the presentation did not look familiar, and that he did not recall any presentations about the BRC to the SDCERS Board. Ms. Miller asked him what steps the Board took to implement the recommendations of the BRC. He responded that the SDCERS Board was doing things to change their investment structure to improve their profitability. He noted also that Doug McCalla (SDCERS Chief Investment Officer) began making quarterly presentations about investments and the health of the system.

Ms. Miller asked Mr. Hogquist for the purpose of these financial presentations, specifically whether they were just to update the Board, or in preparation for a vote. Mr. Hogquist replied that the presentations were mostly just informative. Certain of these presentations were given only to the Investment Committee, who would then propose investments to the Board. These issues would spark a full debate, and Mr. Hogquist recalled a particular discussion regarding the return that real estate investments must demonstrate before the Board could make that type of investment. Mr. Turner asked Mr. Hogquist about the changes the Board was considering to increase investment returns. Mr. Hogquist replied that the Board was considering making investments in real estate investment trusts, and was seeking investments that were undervalued so they could sell them at a profit. Mr. Turner asked who had decided on these investments and he replied that these decisions were suggested both by staff and outside consultants.

Other Pension Reform Issues

Ms. Miller then asked Mr. Hogquist if he was familiar with the Mercer Best Practices Audit, and he replied that he was. He was interviewed for this audit, and recalled that

certain of Mercer's proposals were implemented, some were modified, and some were rejected. He stated that these proposals were first evaluated by the Audit Committee of the SDCERS Board, and then voted upon by the full Board. Some of the implemented recommendations were the creation of a timeline for responding to employee inquiries, the hiring of additional staff, and the modification of financial information to make it easier to understand.

Disclosure Issues

Ms. Miller asked Mr. Hogquist to explain his understanding of the SDCERS Board's responsibility for bond disclosures. According to Mr. Hogquist, the City, not SDCERS, had responsibility for bond disclosures because the bonds represented a liability of the City. Ms. Miller asked if the Board was ever asked to review financial information given by SDCERS to the City, and he replied that he did not recall. Ms. Miller asked if the SDCERS Board was involved in the description of the *Corbett* lawsuit in disclosure documents. Mr. Hogquist responded that the Board was involved in the description of the *Corbett* disclosure. He noted that the City changed the retirement benefits as a result of this settlement, although the City never performed an actuarial study to determine the effect of these new benefits on the pension trust. He did not recall any action by the Board to remedy this. The Board was also given an opportunity to review certain text from the *Gleason* settlement, which was discussed during closed session, but he does not know who was responsible for the disclosure of that lawsuit.

Shipione Allegations

Diann Shipione left the Board at the same time as Mr. Hogquist. Ms. Miller asked him for his opinion of her. He replied that he has a very "mixed feeling" of Ms. Shipione because he feels she did the important job of bringing certain information to the public, but also did a disservice by monopolizing the Board's time and keeping it from addressing the members' individual benefits that came before them. Mr. Hogquist thought that the cameras in Board meetings were to keep her from berating people, specifically SDCERS staff. He thought that the staff might get "spiteful" towards Ms. Shipione as a result of her poor attitude towards them. Mr. Hogquist got the impression that certain Board members disliked Ms. Shipione and did not take her seriously, but he did not know why and did not want to speculate.

Mr. Hogquist was shown a memo from Diann Shipione to the SDCERS Board, dated June 7, 2004, entitled "Abrogation Statement" (Exhibit 2). Mr. Hogquist remembered receiving this email, and stated that Board members did not usually communicate via email, but Ms. Shipione did. Ms. Miller asked if he had a recollection about the subject matter of this memo, and he stated that he did not. Ms. Miller asked about her reference to an "emergency resolution," and Mr. Hogquist replied that he did not recall this reference. He stated that she used the term "slippery slope" often. Ms. Miller asked specifically if he knew about two of the recipients of this memo, Mike Leone and Reg Vitek. He responded that they both worked for Selzer Caplan McMahon Vitek, and were hired by the Board to handle lawsuit issues. Ms. Miller asked if he had an opinion on the advice they gave, and Mr. Hogquist replied that he did not.

Mr. Hogquist was shown a memo from Ms. Shipione to the City Council, dated October 10, 2004 (Exhibit 3). This memo concerned GASB standards, and while Mr. Hogquist did not recall this memo in particular, he did recall general discussions about these standards.

Ms. Shipione had been concerned that certain liabilities were not present on financial disclosures, but Mr. Hogquist did not recall the specifics of this issue. Ms. Miller asked if he understood her references to contributions and he stated that he did not recall this issue or any presentation about it.

Remediation

Ms. Miller asked Mr. Hogquist if there was any other information that knew that he felt was relevant to the Audit Committee's investigation. Mr. Hogquist commented that while the City Council is the SDCERS plan sponsor, the Council always claimed that they have no knowledge of the retirement system, even though SDCERS Board minutes are public. Mr. Hogquist also believed that someone intentionally kept SDCERS proposals off the City Council docket. He lamented the fact that there is no mechanism for the SDCERS Board to interact with the Councilmembers and force them to take responsibility for the system. In this regard, Mr. Hogquist felt that Ms. Shipione's ire was misplaced; she should have been upset towards the Mayor and Council, since the Council has control over the Municipal Code which governs SDCERS.

Mr. Turner asked why Ms. Shipione was angry towards SDCERS staff. Mr. Hogquist replied that he did not know, but that it might have something to do with her husband. Mr. Hogquist thought that she may have been acting that way intentionally to unseat the Mayor.

Ms. Miller asked if the City Council was reluctant to solve the pension problems. Mr. Hogquist responded that an aide to Councilmember Atkins had been contacted by some injured officers and he hoped this would bring certain issues to the Councilmember's attention. One problem noted by Mr. Hogquist was that the SDCERS Board had to make decisions based on the information they were presented, which might have been incorrectly communicated to them by their staff.

Mr. Turner asked Mr. Hogquist to explain his understanding of the actions in the past which led to the current investigations. Mr. Hogquist responded that Ms. Shipione brought information to light regarding problems that some people were trying to fix, but that others were trying to ignore. He felt that City Attorney Aguirre's reports were only feeding a media frenzy, and that all the money paid for investigations could go towards the UAAL. While some people probably benefited personally from the deals in question, Mr. Hogquist believed that many people had only the best interests of the system at heart. He noted that there is too much information for SDCERS Board members to digest considering they hold other full-time employment, and observed that all Board members "are there for different reasons."

Mr. Turner asked Mr. Hogquist what recommendations he would include if he were writing the Audit Committee's Report. Mr. Hogquist suggested the complete separation of SDCERS from the City, since he did not want to see pension funds used to balance the City's other liabilities. He suggested that the waterfall should be fixed, and that the health care trust should not be operated on a pay-as-you-go basis. He reiterated that the Council is the plan sponsor, but the rules governing the system are unclear and officials shirk responsibility. Mr. Hogquist believed that potential candidates for the SDCERS Board are now afraid to sit on the Board because of liability concerns. Mr. Turner ended the interview by asking Mr. Hogquist to contact him if he has any further suggestions.

WF&G

3242187

EXHIBIT 1

SAN DIEGO CITY EMPLOYEES RETIREMENT SYSTEM:

REPORT ON THE MAYOR'S BLUE RIBBON COMMITTEE ON CITY FINANCES

2/6/2003

CAR00101

Outline of Today's Meeting

- Background of SDCERS
- Defining the Issues
- Historical Perspective and Contingent Benefits
- Looking into the Future
- Corridor Funding (the Manager's Proposals) and Health Insurance
- Funding Alternatives and Discussion

2/6/2003

2

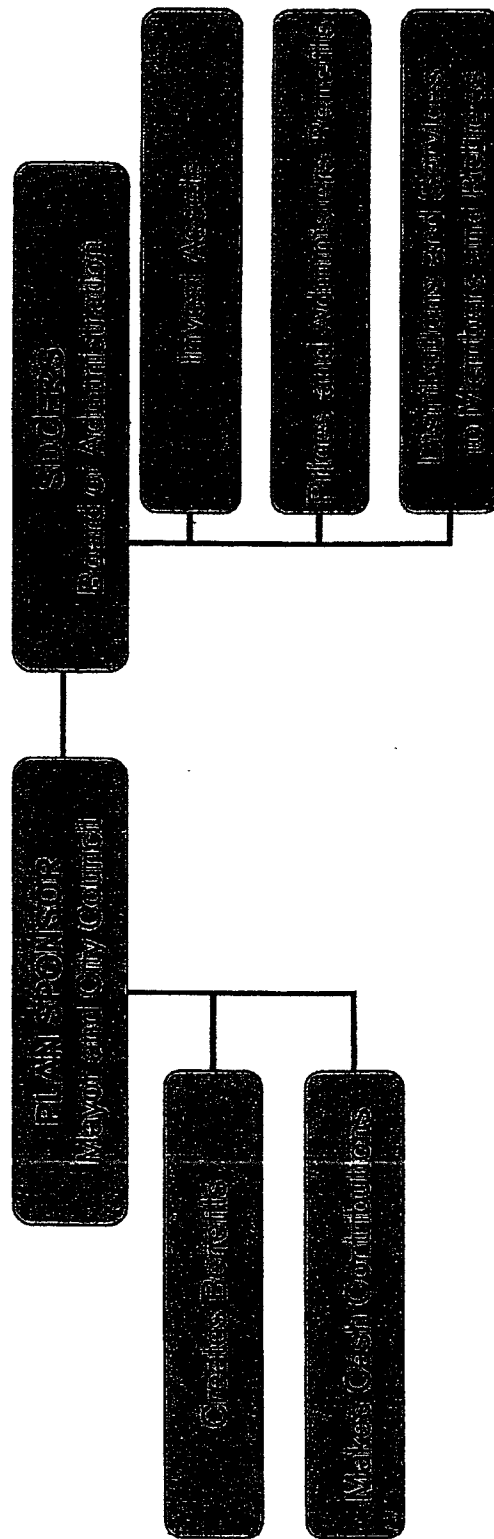
SDCERS: WHO WE ARE

- SDCERS is responsible for administering and managing the defined benefit retirement funds for the City of San Diego, the Unified Port District and the Airport Authority (the Plan Sponsors), and for their General Members, Safety Members, Elected Officers and Retirees.
- Roles and Responsibilities: the City Council, as the Plan Sponsor, establishes benefits and makes contributions to support benefits; SDCERS invests the assets to reduce future City contributions, administers the benefits and provides the cost of these benefits.

2/6/2003

3

Roles and Responsibilities



2/6/2003

SDCERS: WHO WE ARE

- The 13 Member Retirement Board is comprised of:
 - 3 representatives from the City (Manager, Auditor and Treasurer, or designees);
 - 4 citizens appointed by the City Council;
 - 3 representatives elected by General Members;
 - 2 representatives elected by police and fire safety members (one of each), and
 - 1 representative elected by retired members.

2/6/2003

5

SDCERS: WHO WE ARE

- The Membership in the Fund as of June 30, 2002:

	<u>City Plan</u>	<u>UPD Plan</u>
Active General Employees	9,359	763
Active Safety Employees	3,323	188
Retirees	4,569	259
TOTAL	17,242	1,210

2/6/2003

6

SDCERS: CURRENT STATUS

- The Investments of the Fund as of
December 31, 2002:

Equities (51.0%)	\$1,228,211,382
Fixed Income (38.7%)	\$932,300,222
Real Estate (10.1%)	\$243,665,393
Cash (0.2%)	\$5,194,336
TOTAL MARKET VALUE	\$2,409,371,333

2/6/2003

7

SDCERS INVESTMENT PERFORMANCE

Despite difficult market conditions, the SDCERS Retirement Fund has performed in the top 15% of performance for Public Funds for the past one year, three years and five years:

Fund's 1,3 & 5 year Annualized Returns (as of 6/30/02)	-2.48%, +3.69%, & +6.97%
Average Public Fund's 1,3 & 5 year Annualized Returns (as of 6/30/02)	-5.15%, +0.52%, & +5.57%

2/6/2003

8

SDCERS RETIREMENT TRUST FUND

Target Rate of Return (actuarial rate)	8%
Funding Ratio as of 6/30/02 (PUC Funding Method)	77.3%
Total Liabilities as of 6/30/02	\$3.17 billion
Total Assets as of 6/30/02 (market value)	\$2.53 billion
Total Assets as of 6/30/02 (actuarial value)	\$2.45 billion
Unfunded Liability as of 6/30/02 (actuarial value)	\$720 million

2/6/2003

9

DEFINING THE ISSUES – WHY ARE WE HERE TODAY?

Responding to the Blue Ribbon Committee Report

- The Committee had two concerns:
 - Whether the City is paying out of its current year's budget the full cost being incurred by its current workforce for their future pension & retiree health benefits.
 - Whether the budgetary process adequately comprehends the steadily growing annual expense obligation, particularly given the uncontrollable & non-discretionary nature of this liability.

2/6/2003

10

DEFINING THE ISSUES – WHY ARE WE HERE TODAY?

The Blue Ribbon Committee had two recommendations:

- Change the City's funding strategy to one that results in the City fully funding, on a current basis, its future obligations earned today which includes the pension benefits as well as health benefits.
- Obtain a current & comprehensive analysis of projected pension expenses & revenue sources, which includes the current present value of retiree health benefits to determine the impact on future City finances.

2/6/2003

11

DEFINING THE ISSUES – WHY ARE WE HERE TODAY?

SDCERS summary analysis of the Blue Ribbon Committee's Report confirms the following:

1. The City is not paying out of current year's budget the full cost being incurred... for future pension & retiree health benefits.
2. There is a very significant growth in required annual pension cost which the City's budget must fund.

2/6/2003

12

SDCERS: HISTORICAL PERSPECTIVE

As recently as two years ago, when the investment markets were very strong,

- The S&P 500's annualized return for 1, 3 and 5 fiscal years was +7.24%, +19.6% and +23.8%.
- The Retirement Fund was well funded with a funding ratio (ratio of assets to liabilities) of 97.3% as of 6/30/00.

2/6/2003

13

SDCERS: HISTORICAL PERSPECTIVE

Over the last two years,

- The S&P 500 returned -14.83% in FY 2001 and -17.99% in FY 2002.
- The City settled the Corbett lawsuit resulting in an increased liability of \$158 million plus an on-going contingent liability of approximately \$5.5 million per year for retirees.
- Retirement Benefit Factors for General Members were increased from 2.0% to 2.25% on 7/1/00, and from 2.25% to 2.50% on 7/1/02. This equates to a 25% increase in the average pension for General Member retirees in two years.

2/6/2003

14

SDCERS: HISTORICAL PERSPECTIVE

- The Plan benefited greatly (e.g. good funding ratio) as a result of the unprecedented investment market boom of the '90's.
- The Plan suffered from the "bubble burst" and sizeable losses in the investment markets of the last 3 years.
- However, over the long run the Plan's investment returns have exceeded the actuarial earnings assumption of 8%/yr (even including the losses of the recent past):
 - 10 year average annual returns through 6/1992 = 14.34%
 - 10 year average annual returns through 6/2002 = 9.26%

2/6/2003

15

SDCERS CORRIDOR FUNDING: WHAT IS IT?

- In 1996, the City and the Retirement Board reached agreement on a proposal (the Manager's Proposal) to stabilize the City's annual employer contribution to the Fund. This Proposal allowed the City to contribute less than the actuarially computed contribution rate.
- Under the Manager's Proposal, the City's employer contribution rate increased 0.5% of payroll per year even though the actuarially computed rate increased more than 0.5% of payroll per year.

2/6/2003

16

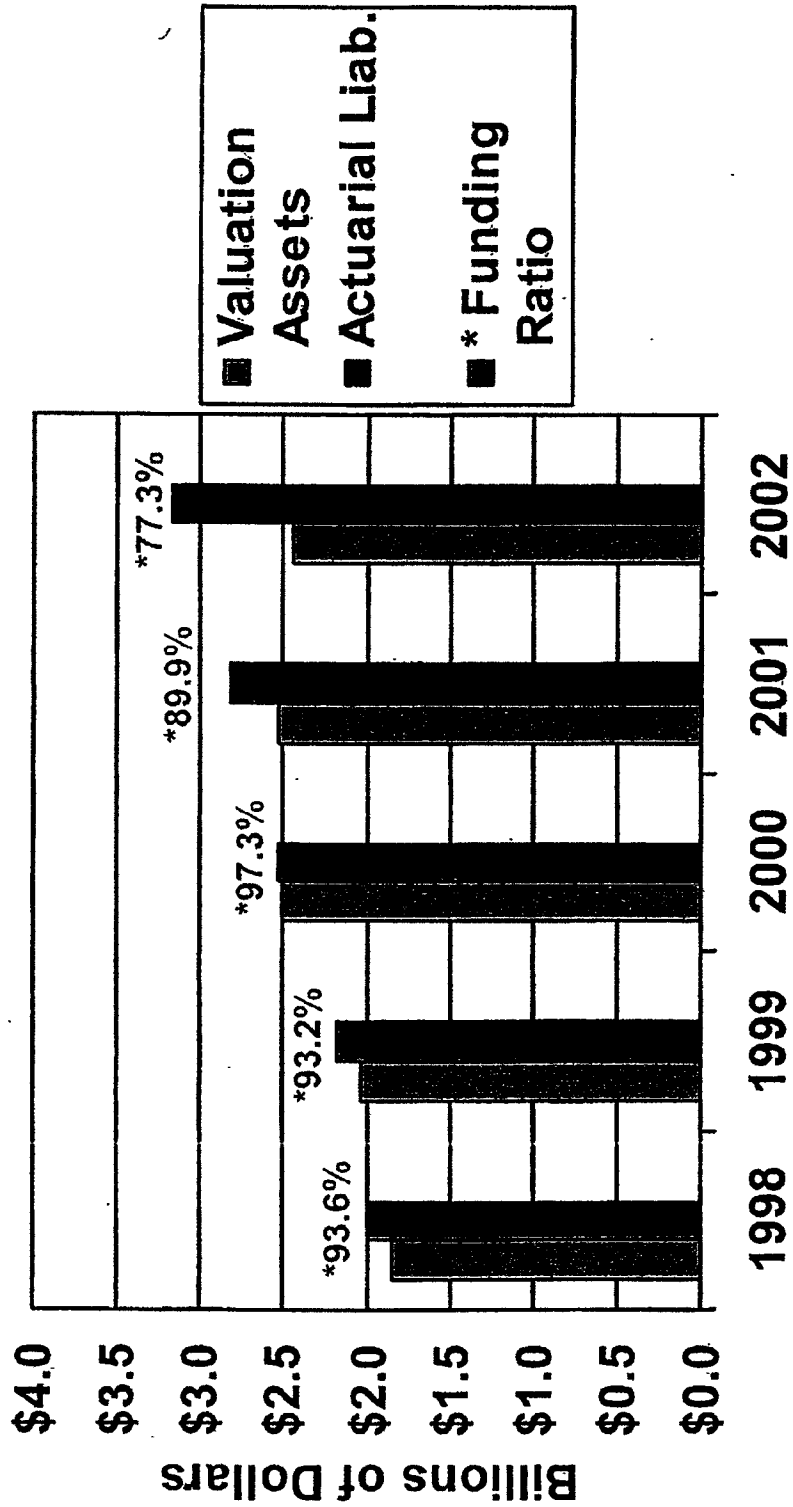
SDCERS CORRIDOR FUNDING: WHAT HAVE BEEN THE RESULTS?

- From 7/1/97 through 6/30/03, the difference between what was contributed by the City and what would have been contributed under the amounts computed by the actuary, plus earnings on the difference, results in a funding shortfall of approximately \$102 million.
- New Manager's Proposal II has been approved by the City, the Retirement Board and Members which requires the City to "ramp up" its employer contributions each year until it achieves the actuarially computed PUC funding rate by 2009.

2/6/2003

17

FUNDING HISTORY



2/6/2003

FUNDING HISTORY

Fiscal Year End (June 30)	City Employer Contribution Rate	Actuarial Contribution Rate	Contribution Shortfall (in millions)
1998	7.83%	10.87%	\$11.1
1999	8.33%	10.86%	\$ 9.7
2000	8.83%	11.48%	\$10.6
2001	9.33%	11.96%	\$11.2
2002	9.83%	12.58%	\$12.3
2003	10.33%	15.59%	\$25.3
TOTAL	CUMULATIVE	IMPACT =	\$80.2
TOTAL	COMPOUNDED	IMPACT (8%) =	\$102.1

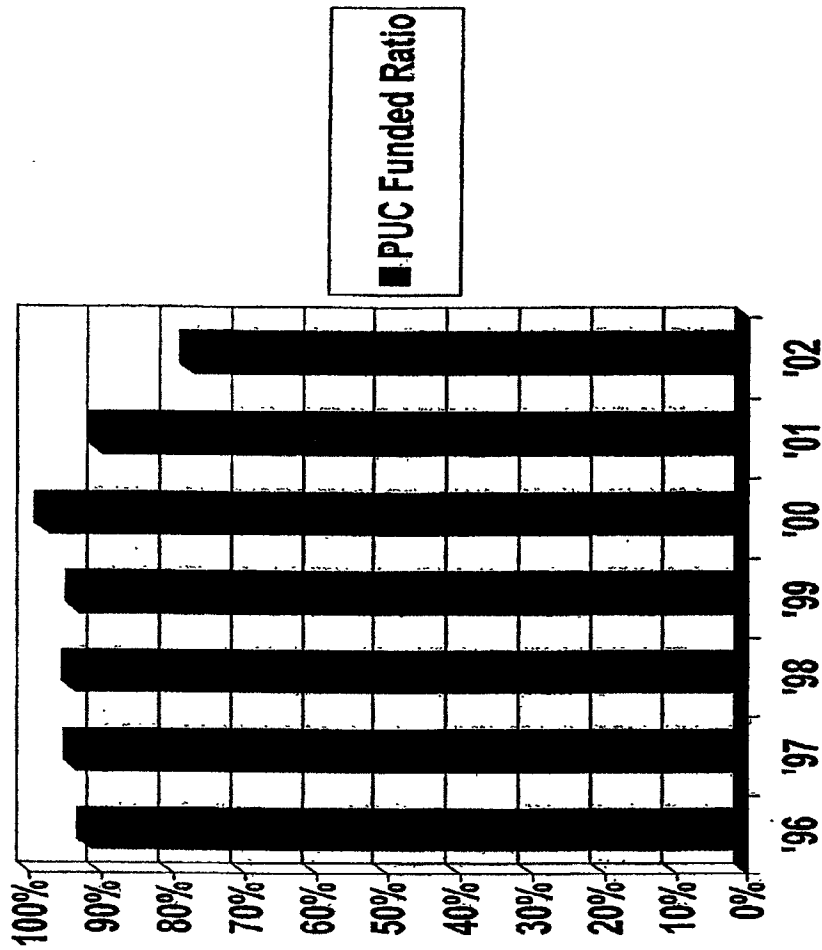
2/6/2003

19

CAR00119

PUC FUNDING RATIO (ratio of assets to liabilities)

FY Year End	Funded Ratio
1996	91.4%
1997	93.3%
1998	93.6%
1999	93.2%
2000	97.3%
2001	89.9%
2002	77.3%



2/6/2003

SDCERS: CONTINGENT BENEFITS

- Contingent Benefits are benefits which are only paid each year if the Fund generates "excess" realized earnings. There is a hierarchy defined in the Municipal Code for paying these benefits until all of the "excess" realized earnings are paid out in a given year.
- The Contingent Benefits of the Fund, in the order prescribed by the Municipal Code, include:
 - the Reserve for Retiree Health Insurance;
 - the 13th check;
 - the Corbett Payment;
 - crediting of the Supplemental COLA reserve;
 - crediting of the Employee Contribution reserve

SDCERS: REALIZED EARNINGS

- In the "up" market of recent years, the Retirement Fund's realized earnings were strong, reserves were high and all Contingent Benefits were paid.
- The trend has changed. Realized earnings as of 6/30/02 were \$51.2 million, insufficient to pay all Contingent Benefits.

Year	Realized Earnings	All Contingent Benefits paid
1999	\$189.3 Mil	Yes
2000	\$415.9 Mil	Yes
2001	\$168.0 Mil	Yes
2002	\$51.2 Mil	No
2003 (as of 11/30/02)	- \$55.5 Mil	Unlikely

SDCERS: CONTINGENT BENEFITS

Contingent Benefit	Paid Since	Avg. Total Annual Cost	Number of retirees receiving payment
Health Insurance	1982	\$10 million	3,543
13 th Check	1980	\$3.8 million	4,695
Corbett	2000	\$5.5 million	4,267

2/6/2003

23

PROJECTIONS OF CONTINGENT BENEFITS COST AND LIABILITIES

Contingent Benefit	Amt Pd from inception to 6/30/02	Total Amount of last annual Payment	Projected Payment FY '03	Projected Liabilities (Present Value in Today's Dollars)
Health Insurance	\$56.8 million	\$9.5 million	\$10 million	\$1.1 Billion
13 th Check	\$58.0 million	\$3.8 million	Not paid	\$58 million
Corbett	\$28.9 million	\$5.6 million	Not paid	\$75 million
Employee Cont Rate Reserve	\$15.3 million	\$3.2 million	Not Paid	\$0
Sub COLA Reserve	\$11.0 million	\$2.8 million	Not Paid	\$0
TOTAL	\$170.0 million	\$24.9 million	\$10 million	\$1.23 Billion

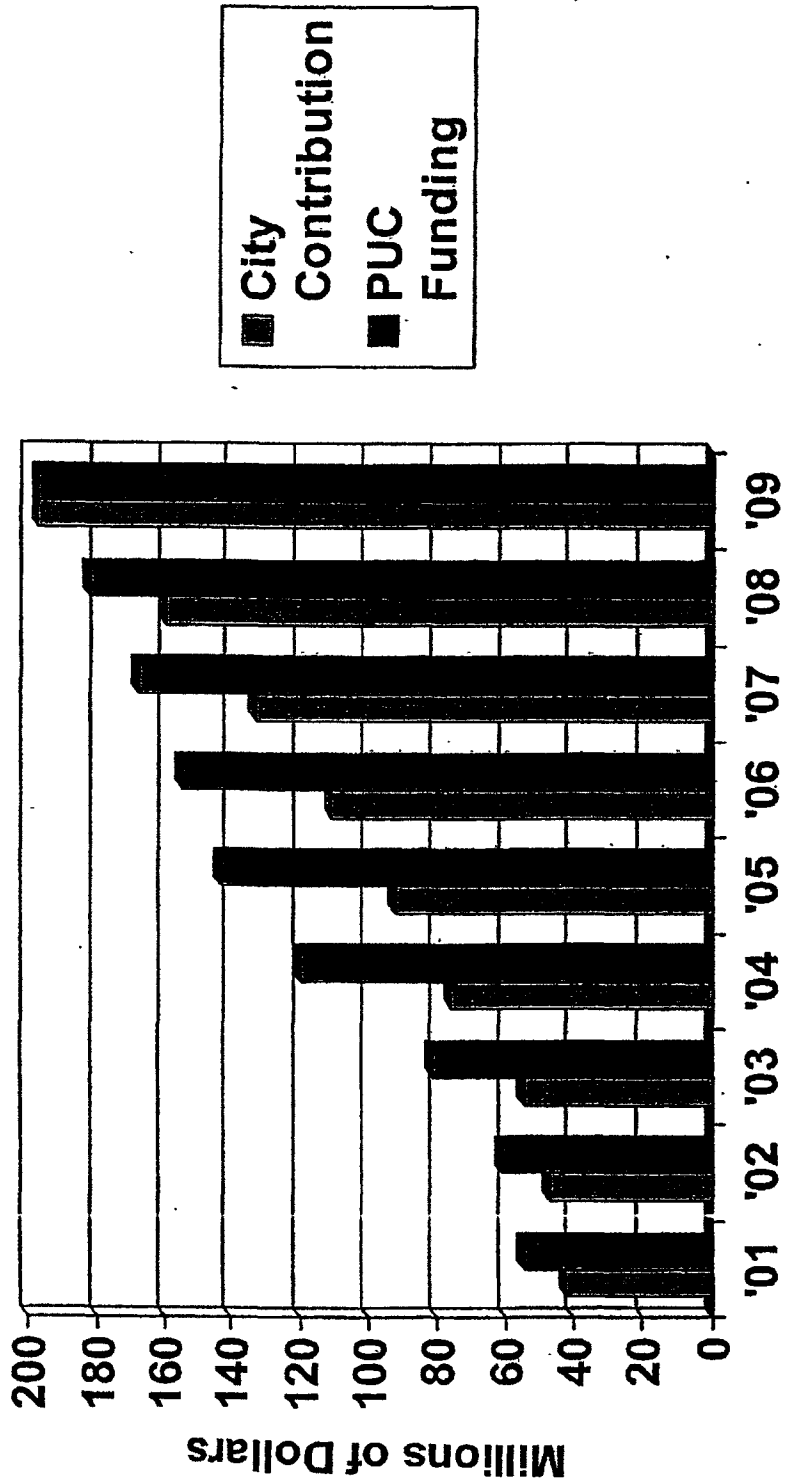
2/6/2003

24

PROJECTIONS INTO THE FUTURE

- This year's City Employer Contribution was \$54 million, or 10.33% of payroll (the City also paid another \$28 million on behalf of employees' required contribution – the Offset).
- By 2009, assuming covered payroll increases by 4.25% per year, the actuarial contribution rate increases 3% next year due to increased benefits, and 1% per year thereafter, the City's payment in 2009 would be \$197 million (this does not include the amount of any City offset payments towards employee contributions).
- If Contingent Benefits are also paid by the City in 2009, assuming no "excess" earnings in the intervening years, the contribution would have to increase by another \$57 million to \$254 million.

THE CONTRIBUTION SHORTFALL



2/6/2003

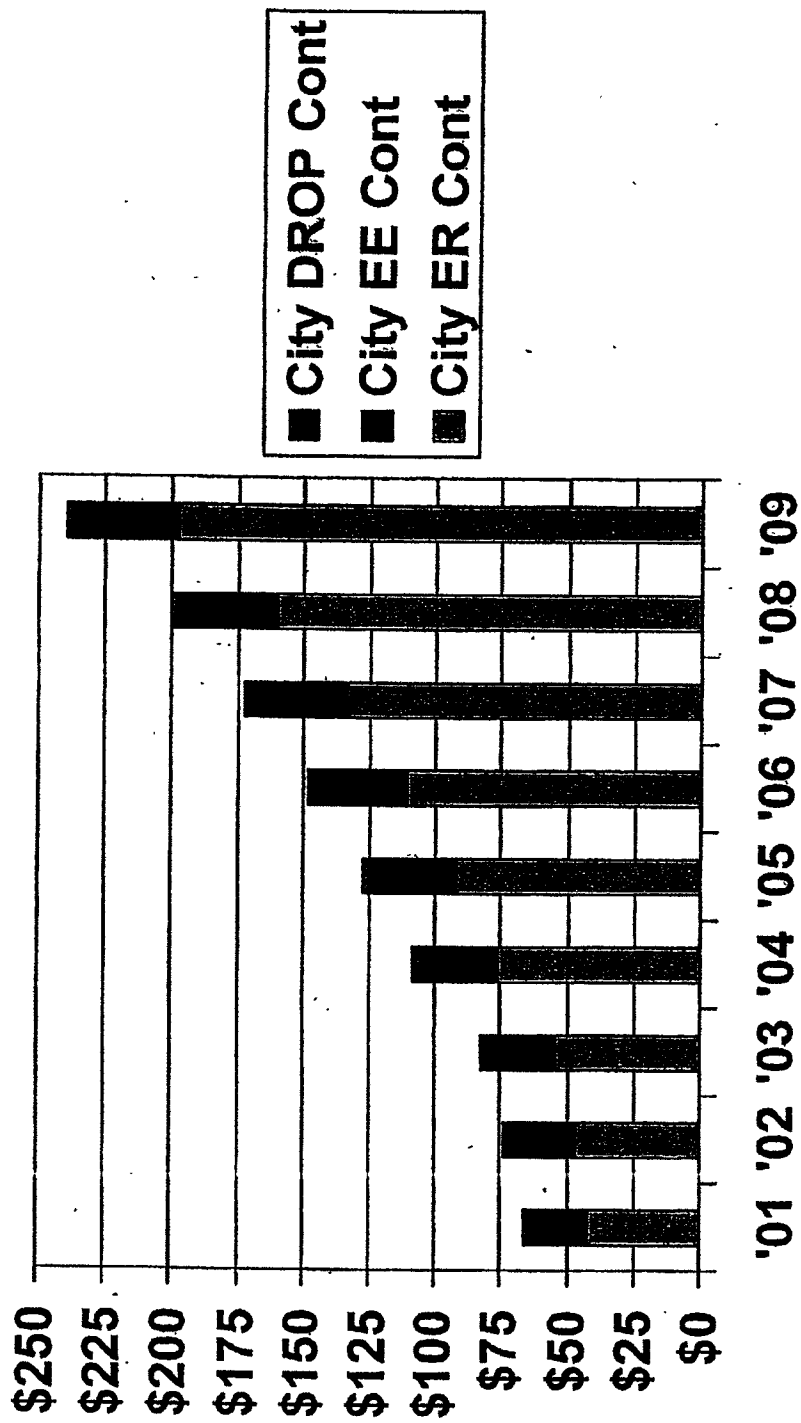
A PROJECTED FUNDING FUTURE

Year	City Employer Contribution	City Employee Contribution	City DROP Contribution	Total Contribution
2001	\$42 million	\$23 million	\$1.0 million	\$66.0 million
2002	\$47 million	\$26 million	\$1.1 million	\$74.1 million
2003	\$54 million	\$28 million	\$1.2 million	\$83.2 million
2004	\$76 million	\$31 million	\$1.3 million	\$108.3 million
2005	\$92 million	\$34 million	\$1.4 million	\$127.4 million
2006	\$111 million	\$36 million**	\$1.4 million	\$148.4 million
2007	\$133 million	\$38 million**	\$1.5 million	\$172.5 million
2008	\$160 million	\$39 million**	\$1.6 million	\$200.6 million
2009	\$197 million	\$41 million**	\$1.6 million	\$239.6 million

**assumes Employee Rate Reserve is depleted and Offset contributions not made by the City.

2/6/2003

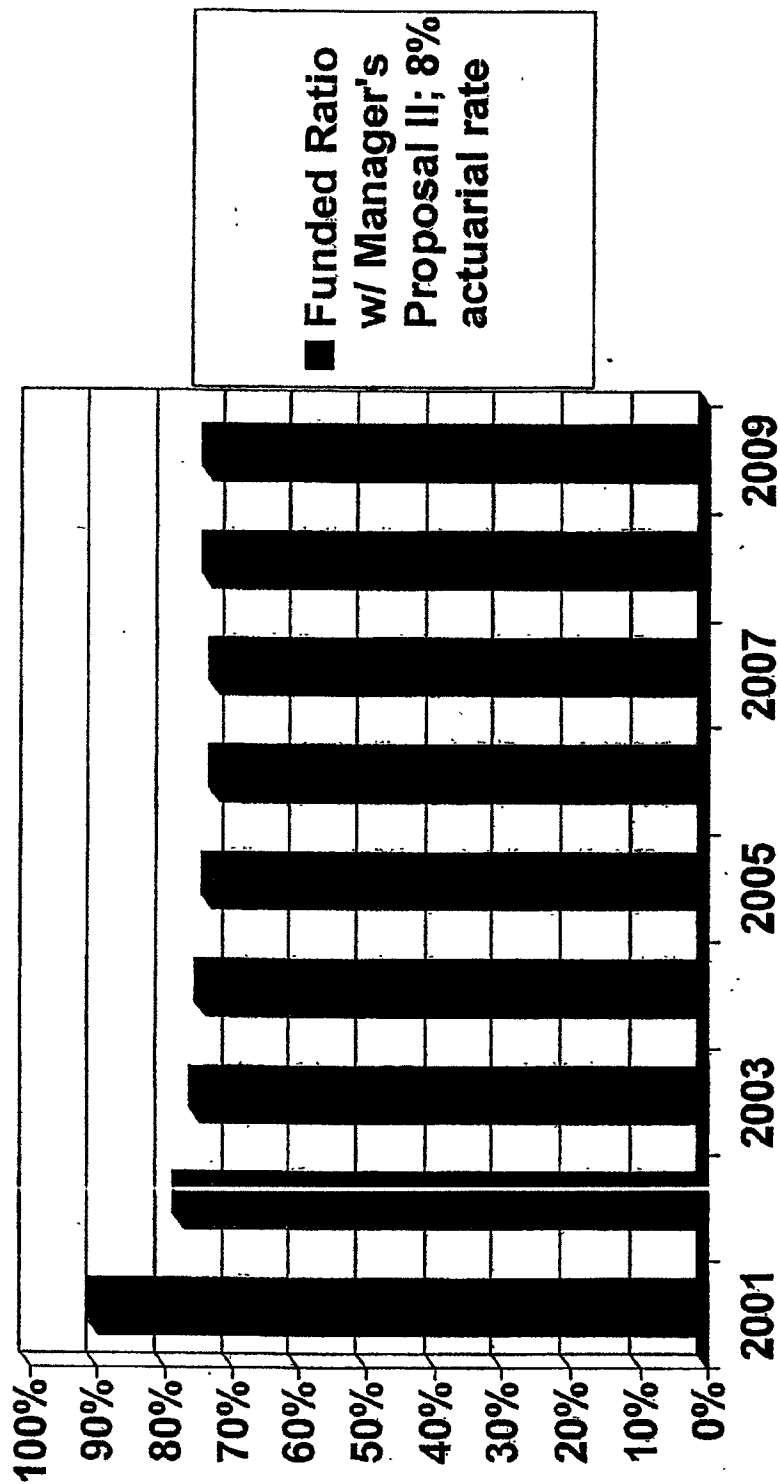
FUNDING PROJECTIONS



2/6/2003

PROJECTED PUC FUNDING RATIO

(ratio of assets to liabilities)



2/6/2003

SDCERS: HEALTH INSURANCE TODAY

- Current benefits provide for payment of the premiums for eligible retirees' health insurance from SDCERS' "surplus earnings".
- Two Health Insurance reserves within the Retirement Fund will cover the payment of premiums for approximately 2 to 3 years.
- After these reserves are depleted, the City is obligated to pay from other funds (current cost is approximately \$10million per year).

SDCERS: HEALTH INSURANCE IN THE FUTURE

- The actuarial liability of the City's retiree health insurance commitment is not required to be actuarially funded. Therefore, it is not included in the calculation of the City's contribution to the Retirement Fund.
- The City, through the Retirement Fund, is only paying health insurance premiums for current retirees – no contributions are being made for the future health insurance liability of today's employees. Thus future taxpayers may have to pay for prior year's expense which will become a significant annual cost.

2/6/2003

31

MAXIMUM PROJECTED LIABILITIES OF PENSION, CONTINGENT AND HEALTH

Unfunded Pension Liability (6/30/02)	\$720 million
13 th Check and Retiree Health Insurance	\$433 million
Future Retiree Health Insurance	\$750 million
Corbett Contingent Benefit	\$75 million
TOTAL	\$1.978 Billion

2/6/2003

32

SDCERS: ANALYSIS OF ALTERNATIVES

1. Maintain Status Quo: City's annual cost will increase approximately 16% to 18% each year until 2009. Thereafter, increases will continue to grow in order to shift from PUC to EAN funding.
2. Issue Pension Obligation Bonds with the objective of reducing the unfunded liability.
3. Increase the Contribution Rate now to improve future actuarial funding.
4. Do both #2 and #3 to achieve full funding.

2/6/2003

33

EXHIBIT 2

sd CERS
San Diego City Employees'
Retirement System

TO: . SDCERS Board Of Directors Trustees
Mike Leone and Reg Vitek, Selzer Caplan
Dan Riesenber, Bill Waller, Jan Webster, Pillsbury Winthrop
Rick Roeder, GRS
Nell Hennessey, Esq.
SDCERS Administrator Larry Grissom
FROM: Diann Shipione, Trustee
DATE: June 7, 2004
RE: **ABROGATION STATEMENT**

This 'emergency' Resolution on less than one business day's notice, is the next step down the slippery slope of irresponsible and illegal actions taken by this board.

It is only needed because of the now open recognition by our advisors that the Board's various underfunding actions taken in the past and facilitating the enormous billion dollar balloon of City debt, were each the result of votes taken by self-interested Trustees who, but for the variety of money benefits hidden in these Manager Proposal agreements, would *never* have tolerated such behavior by the City.

Because the funding problem has now grown overwhelming, and because there are more votes that need to be taken to keep this fraud alive, the Board is now in the ridiculous position of having to unilaterally 'abrogate' an existing state statute; like we have such power. This would be a joke if it were not so dangerous.

State statutes apply to everyone. Those, like members of this Board, who find themselves in a self-imposed situation where previous self-dealing is proving to be inconvenient, do not get a free pass.

And, of course, our method of dealing with this inconvenient statute is equally irregular.

Determining that statutes don't apply to you, especially where the consequences can be so severe, is usually done by getting a court decision. But do we take that prudent action? No we pompously just 'abrogate' the statute on our own. By our own 'resolution'.

There is no need to 'abrogate' any law if we just return to the job we have as specifically defined by the City Charter. Require full annual actuarial funding of the pension contribution from the City, and not participate in the illegal and hidden accrued deficit that uses our System's funds as a secret bank for politicians.

But, so long as the persons on this board continue to vote their self-interests, actions like this one will be necessary to mask over the problem in hope that no one will be called on to account. I doubt it will work.

I oppose this resolution and all other direct or indirect actions of this board to continue facilitating the underfunding practice.

I request this memo be made part of the record of this meeting and be included in June's Board package.

EXHIBIT 3

From: Diann Shipione Shea

Sent: Monday, October 11, 2004 12:13:06 AM

To: Dick Murphy; Toni Atkins; Donna Frye; Jim Madaffer; Brian Maienschein; 'Councilmember Scott Peters'; Michael Zucchet; Ralph Inzunza

Subject: Concerns RE GASB, GAAP, Funding & Contributions

*sd CERS
San Diego City Employees'
Retirement System*

TO: KPMG Audit Team

FROM: Diann Shipione, Trustee

CC: San Diego City Council
Vinson & Elkins
City Manager Lamont Ewell
SDCERS Board

DATE: 10/10/04

RE: **CONCERNS RE GASB, GAAP, FUNDING & CONTRIBUTIONS**

Historically the pension funding practice may not have complied with various reporting requirements and standards including those recommended by, but not limited to, GASB Statements Nos. 25, 26, and 27.

The annual required contribution (ARC) to the City's retirement system may not have been calculated to include all benefits paid by system assets such as the "13th Check", Contingent Corbett, STAR COLA, etc.

In addition, the deduction of the annual payment for the retiree health care benefit further reduced the pension contribution. This resulted in a lesser actual amount of pension contribution than has been reported.

The pension contribution is referred to in several ways: "rates calculated by the actuary"[1], "full actuarial rates"[2], "full actuarially calculated rates"[3], "actuarially calculated contribution rates"[4], "full actuarial payments"[5], "full actuarially required rates"[6], and "actuarially required contributions (ARC)"[7].

665064
665105

None of these terms are the annual required contribution (the ARC) calculated by the System's actuary of record using recommended assumptions and best practices including all benefits paid.

Confirmation that employer and employee contributions were actually received timely and the amounts received were accurate may require review.

Additional contribution shortfalls may have resulted from:

- The use of a "one-year lag" in conjunction with Manager's Proposals 1 & 2. Going forward this may also be true under the Gleason Lawsuit settlement agreement.
- DROP not being cost neutral as noted by Mercer, the SDCERS external auditor.[8]
- The allocation of assets to the UPD and Airport authority based on the actuarial value of assets instead of market value.
- A large number of members who did not have sufficient data, according to page 11 of Mercer's May 11, 2004 Audit of Actuarial
- Inactive members with compensation data for the period following their separation – many were terminated in 2000.

[1] Execution Copy of the Gleason Lawsuit Settlement Agreement, p. 5.

[2] Page 3 of City Manager's Report No. 04-148, July 7, 2004, Approval of Settlement Agreement in Gleason v. SDCERS, et al.

[3] IBID.

[4] Page 6 of the Notice of Proposed Settlement and Fairness Hearing, May 26, 2004.

[5] Mayor Dick Murphy, San Diego Union Tribune, 10/3/04, p.G4, "As part of our settlement in the lawsuit ...we've agreed to make full actuarial payments in fiscal year '06, fiscal year '07, fiscal year '08..."

[6] Report On Investigation, City of San Diego, California's Disclosures of Obligation to Fund the San Diego City Employees' Retirement System and Related Disclosure Practices, 1996-2004, With Recommended Procedures and Changes to the Municipal Code, September 16, 2004, Paul S. Maco & Richard C. Sauer, Vinson & Elkins, L.L.P., Washington, D.C., page 29.

[7] V&E, p. 232.

[8] Mercer's Second Addendum To Audit of Actuarial Work dated August 11, 2004, which states on page 7, "...the DROP program is not cost-neutral."